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Reverse Mortgages can Help Fund Retirement

Singapore Management University

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But a well-designed contract and the education of retirees are important if they are to reap the benefits.

To a retired homeowner with limited income and who needs more cash for his daily expenses, the idea of a reverse mortgage should sound enticing. The arrangement allows him to convert part of the equity in his home into cash; he does not have to worry about monthly payments as long as he lives in the home; and he does not have to repay the loan until the home is sold or vacated.

Yet, reverse mortgages have not really caught on in the US and most other countries, says **Robert C. Merton**, Distinguished Professor of Finance at the MIT Sloan School of Business, and the winner of the 1997 Nobel Prize in Economics.

Merton attributes this to a variety of reasons – poorly designed contracts, high fees, cumbersome origination process as well as a lack of understanding and education.

“(The availability of reverse mortgages) should be an important part of every retirement system,” he says. “For a large portion of the retiree population, I believe it can make a good retirement experience possible when a substandard one is otherwise the alternative. The potential pitfalls can be largely avoided by a well-designed standardised contract with regulation requiring substantial disclosures for any deviation in contract terms and by provisions such as monthly payouts of the mortgage proceeds instead of a single lump sum distribution, which can protect against unwise use of the cash."

Merton, who was at the Singapore Management University SKBI Public Lecture, "Meeting Global Challenges of Funding Retirement", adds: "A well-designed reverse mortgage is a terrific idea. Its execution, however, is key."

For instance, Merton likens getting a reverse mortgage in the US to investing, where some funds have high fees and others have low amounts. "A well-designed reverse mortgage does not have lots of fees. The contract itself ought to be standardised where there aren't any funny terms, such as 30 percent of price appreciation going to the mortgagee."

He added: "In the US, states require a third-party advisor to sign off on (the contract) – it's clunky and expensive. Once reverse mortgages take off, such contracts would become more widespread and are likely to become more standardised. Then we won't need third parties.

Beware the pitfalls

As with any product, a poorly designed reverse mortgage that is sold using unscrupulous sales tactics can put the largest asset of a retiree at risk.

Borrowers do need to repay the mortgage – loan amount plus interest – when they sell the property or move out of the house. For instance, if the borrower becomes frail and moves into a nursing home, the loan becomes due. If he is unable to pay, the house is sold or foreclosed and others living in the house have to move out..

If the borrower dies, his heirs have the option of keeping the house by paying off the mortgage. In both the US and Canada, if the borrower has lived long enough to incur enough interest that the amount owed exceeds the fair market value of the house, the estate does not have to pay more than the house's worth. In some countries, however, the estate can be held liable for paying.

For those who wish to leave the house to their children, a reverse mortgage may not seem like a good idea. However, Merton notes that such thoughts are outdated as the retirees' offspring would likely not be living in the house.

"In an agrarian society, a farmer will farm the land, and then pass the land and house to his children. However, in an industrial society, the children move to the city so this is not applicable," Merton explains.

He adds: "The house is both a stream of income as a hedge and an asset. It changes from the former to the latter when the people in the house no longer need it. The reverse mortgage recognises it by saying, 'As long as you're in the house, you pay nothing, even if you live to be 120'.

“When you’re not there, your heirs get the unspent cash from the reverse mortgage and they can sell the house, pay the amount due, keep the difference or let the bank take the house if the amount owed exceeds the value of the house. That’s a wonderful contract!”

Lack of education about reverse mortgages

Another reason why reverse mortgages have not taken off is a lack of understanding, or even awareness of their existence, among retirees. There is also the perception that one takes up a reverse mortgage only when he is desperate for money, Merton notes.

Merton adds: “The other thing is, when people hear the word ‘mortgage’, they think it’s a regular mortgage and worry about what happens when they can’t pay the (monthly) payments. Perhaps it shouldn’t be called a reverse mortgage; perhaps it should be called something else.”

Perhaps the name should better reflect what a reverse mortgage is all about – a means to finance retirement, even though Merton says that most retirees are not or would not be in dire financial straits.

“But most of them are likely to have a much less satisfactory retirement experience, including some amount of reliance on their children, than they could have with the same resources, if they had access to a well-designed reverse mortgage and used it.”

However, Merton is confident reverse mortgages would eventually catch on. “I believe that the retirement funding need for baby boomers in the US and abroad is going to be sufficiently strong that the reverse mortgage will become a standard part of the funding of retirement.”